Appendix A

Declaration of Janusz Ordover

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
Implementation of Section 11 of the Cable Television Consumer Protection and Competition Act of 1992	)	CS Docket No. 98-82
	)	
Implementation of Cable Act Reform	)	CS Docket No. 96-85
	)	
Provisions of the Telecommunications Act of 1996	)	MM Docket No. 92-264
	)	
The Commission's Cable Horizontal and Vertical Ownership Limits and Attribution Rules	)	MM Docket No. 94-150
	)	
Review of the Commission's Regulations Governing Attribution Of Broadcast and Cable/MDS Interests	)	MM Docket No. 92-51
	)	
Review of the Commission's Regulations and Policies Affecting Investment In the Broadcast Industry	)	MM Docket No. 87-154
	)	
Reexamination of the Commission's Cross-Interest Policy	)	

DECLARATION OF
JANUSZ A. ORDOVER
ON BEHALF OF AT&T CORP.

I. QUALIFICATIONS

1. My name is Janusz A. Ordover. I am Professor of Economics and Director of the MA Program at New York University, which I joined in 1973. At New York University, I teach undergraduate and doctoral level courses in industrial organization economics, the

field of economics concerned with competition among business firms and upon which "antitrust economics" is founded. I have devoted most of my professional life to the study and teaching of industrial organization economics and to its application through antitrust and regulatory law and policy.

2. In July 1991, President George Bush appointed me to the position of Deputy Assistant Attorney General for Economics in the Antitrust Division of the Untied States Department of Justice ("DOJ"). In this post, I participated in the drafting of the 1992 Horizontal Merger Guidelines, which have been widely used by courts and antitrust enforcement agencies. In addition, I led many merger reviews that employed and developed methodologies to define relevant markets in merger and other cases. I returned to New York University in 1993.

3. I have been actively involved in the formulation of public policy in the telecommunications sector. I have submitted written and oral testimony for AT&T to the Federal Communications Commission ("Commission" or "FCC") and to the state regulatory commissions in the Midwest, New England, and New York on a number of issues, including the pricing of unbundled network elements and access to bottleneck facilities.

4. I have written extensively on a wide range of antitrust and telecommunications topics, such as mergers and joint ventures, predatory conduct and entry barriers. My antitrust articles have appeared in the *Yale Law Journal*, the *Harvard Law Review*, the *Columbia Law Review*, and many other journals, monographs and books, here and abroad. A full

list of my articles and other professional publications and activities is presented in my *curriculum vitae*, which is attached as Exhibit 1.

5. I have lectured extensively on antitrust topics to the American Bar Association, the International Bar Association, and the Federal Trade Commission ("FTC"). I recently delivered lectures to the FTC during its hearings on the Future of Antitrust Enforcement, which were organized by prior FTC Chairman Robert Pitofsky. I have also lectured on antitrust policy at colleges and universities in the United States and abroad, and at many conferences and meetings sponsored by various legal organizations.

6. I have acted as a consultant on antitrust and other competition matters to the DOJ, the FTC, and the post-communist governments of Poland, Russia, and Hungary. I have also consulted for the World Bank and the Organization for Economic Cooperation and Development in Paris. I have acted as a consultant in numerous antitrust lawsuits and investigations, including market definition and anti-competitive conduct matters for the FTC, DOJ and private clients in the United States, Australia, Germany, the United Kingdom and the European Union. I have extensive experience in the analysis of competitive effects of business strategies, including tying and bundling.

7. Finally, I submitted a White Paper on behalf of AT&T regarding the Commission's cable horizontal ownership limit earlier in this proceeding. *See* Janusz A. Ordover, *The Perils Of Static Analysis Of Unduly Narrow "Markets": Why Even A Cable MSO That Served 45 Percent Or More Of All Current MVPD Subscribers Would Pose No Threat To Video Programmers Or Consumers*, CS Docket No. 98-82 (filed October 1, 1999) (hereinafter

"*Ordover White Paper*"). My central thesis – that an economically sound limit must rely on *dynamic* considerations and reflect the demonstrated ability and willingness of consumers to switch between cable-based and direct broadcast satellite ("DBS")-based multi-video programming distribution ("MVPD") services as well as the ever-changing entertainment alternatives facing consumers and the emergence of new technologies – was a principal basis of the D.C. Circuit's decision to vacate the Commission's prior horizontal limit. *See Time Warner Entertainment Co. v. FCC*, 240 F.3d 1126 (D.C. Cir. 2001).

II. INTRODUCTION AND SUMMARY OF TESTIMONY.

8. Section 613(f) of the Communications Act directs the Commission to adopt only "reasonable limits" on the number of subscribers a cable operator may serve and, in considering the need for such limits, to "take particular account" of "market power," the "market structure, ownership patterns, and other relationships of the cable television industry," and "the dynamic nature of the communications marketplace." 47 U.S.C. § 533(f)(2)(C) & (E). Consistent with that mandate, the Further Notice of Proposed Rulemaking ("*Notice*") in this proceeding seeks comment on whether structural limits on cable ownership concentration are necessary to prevent a cable operator or operators from acquiring and abusing market power over suppliers of video programming in ways that would harm consumers. That is certainly the right question, because in the absence of a serious risk of abuse of market power, government regulation of cable ownership concentration could only harm the public interest by preventing "efficiencies and other

benefits that might be gained through increased ownership and control." 47 U.S.C. § 533(f)(2)(D).

9. Competition policy (as reflected in modern antitrust economics) – seeks to promote overall social welfare. The public interest is furthered by policies that encourage efficient production and distribution of video programming in response to consumer demand; not policies designed to guarantee that particular producers or packagers of video programming earn a profit or obtain carriage on cable. Economics, through a sophisticated assessment of market power and business strategies that may affect market power, provides an established analytical framework for assessing concerns that increased concentration in an industry may harm competition and consumers.

10. In Sections III through VI below, I apply these established economic tools for assessing market power in a dynamic marketplace and conclude that, on the current record, there is no compelling case for structural limits on cable ownership concentration. In part VII, I discuss two "attribution" rules – *i.e.*, the rules which determine whether a particular ownership interest in a cable system means that the number of subscribers served by that system "count" against the stakeholder for purposes of the cable horizontal ownership cap. I demonstrate the economic irrationality of a rule that generally recognizes that a limited partner that has no involvement in a cable company's decisions about which programming to carry has no ability to influence or control those decisions, but absolutely precludes such a finding (which causes all of the subscribers of the partnership to be attributed to the limited partner), whenever the limited partner merely *sells* video programming to the partnership. I also explain why the Commission should not abolish

the "single majority owner" rule. That rule properly exempts from attribution for purposes of the horizontal ownership cap an otherwise attributable minority interest in a cable company when there is a single majority owner of the cable company.

11. Before discussing these issues in detail, however, it is important to recognize a few general principles that are critical to any meaningful economic analysis of the issues raised in the *Notice*.

A. Market Power Over Whom: Continuing Confusion Regarding Possible Theoretical Rationales For Limits On Cable Ownership Concentration.

12. In the past, there has been much confusion over the type of market power that might justify national cable ownership concentration limits. For example, proponents of such regulation frequently claim that the operators of cable systems in some localities have retail market power over cable subscribers. Even if such claims could be supported in the face of both competition from DBS and the many alternative sources of media-based and other types of entertainment, they would be entirely irrelevant to the question whether *national* ownership limits are warranted. The question of cable market power over consumers is a *local* question, as the *Notice* recognizes. *See Notice* ¶ 19 & n.53 (citing precedents). A cable operator's ability, if any, to exercise market power over consumers in a particular geographic area depends upon the alternative sources of video programming distribution available to consumers in *that* geographic area. A cable operator's power, if any, over retail price in Washington, D.C., for example, is simply unaffected by extent of that cable operator's ownership of cable systems in other areas of the country.

13. Thus, I fully agree with the *Notice* that the focus of this proceeding must be in the other direction – the possibility that the MSOs may exercise market power over video programmers. *Notice* ¶ 5. I understand that in the U.S., MSOs often purchase video programming for all of their systems on a national basis, and it is therefore reasonable to examine with economic tools whether cable ownership concentration on a ntional scale could give a cable operator (or operators) undue power over the programmers that supply the cable operators' key input.

14. Inquiries into buyer market power generally focus on the threats of monopsony – *i.e.*, that a purchaser may have the incentive and ability to restrict demand for the input[1] and thereby purchase the input at less than the competitive price – and foreclosure – *i.e.*, that a vertically integrated purchaser with market power may have the incentive and ability to foreclose distribution of programming that competes with its affiliated programming. I address these and other theories of competitive harm below.

B. The Importance of Considering All Of The Alternatives.

15. Like all buyer market power inquiries, this one must consider all of the feasible alternatives available to suppliers, because a supplier's production decisions – and, accordingly, its susceptibility to the exercise of foreclosure power by any purchaser – is necessarily a function of all alternative channels for sale or distribution of the supplier's product. *See Ordover White Paper* at 4-7. Likewise, where a single purchaser is only one of several outlets for sellers of a particular good or service, that purchaser will have

[1] As I explain below, repression of demand for the input may take a form of fewer actual purchases or reduction in the quality of the product purchased.

no ability to exercise monopsony power. Here, unfortunately, the *Notice* retains some of the prior confusion/conflation of market power over retail consumers and market power over programmers. For example, the *Notice* suggests that only entities that compete with cable operators in the U.S. *retail* distribution of multi-video programming (*e.g.*, DBS providers) should be considered in assessing whether cable operators might gain market power over video programming suppliers at higher levels of cable ownership concentration. *See Notice* ¶ 65.

16. Such an artificially narrow inquiry could produce economically meaningless conclusions about buyer market power. To see why, consider the purchase of copper wire by incumbent local telephone companies ("LECs"). Incumbent LECs are presumably large purchasers of copper wire. Because there is little facilities-based retail local telephone competition in most areas (and almost none that does not rely upon the incumbents' local loops), there are presumably few, if any, retail local telephone competitors of the incumbent LECs that purchase even remotely comparable quantities of copper wire. But that does not mean that the incumbents have market power over suppliers of copper or copper wire. To the contrary, copper and copper wire are purchased by many other types of companies, and copper producers therefore have many alternative distribution outlets for their products.

17. The same is true of video programming – there are many important non-MVPD purchasers of video programming, including U.S. broadcasters, foreign cable, satellite, and broadcast distributors and video cassette and DVD distributors. As I explain below, the presence of these alternative sources of revenue is highly relevant to any inquiry into

the extent to which video programmers require carriage on cable to cover their costs and thus to any inquiry regarding any cable MSO's market power over suppliers of programming.

18. Although it is true that the nationwide availability of non-cable MVPD distributors like DBS may alone be sufficient to constrain the alleged power that MSOs may gain over programmers – as detailed below, there is strong evidence that it is – other purchasers of video programming cannot be ignored.

C. Dynamic, Not Static, Market Power Analysis.

19. As the D.C Circuit recognized in the *Time Warner* decision, proper market power analysis is a dynamic, not a static, exercise that recognizes that consumers respond to market signals, shifting to suppliers that improve price and quality and away from those that do not. Likewise, suppliers respond to market signals, targeting rivals that falter by failing to optimize the quality of their consumer offerings. Although static market shares can, in some contexts, serve as meaningful proxies for market power, this is not such a context.[2]

20. DBS providers have sunk the investment to provide nationwide service and are, I understand, today capable of serving virtually all MVPD consumers. Cable suppliers' incentives and ability to take actions that would reduce the quality of their program

[2] For a more complete discussion of indicia of market power *see, e.g.*, Janusz A. Ordover, *Economic Foundations of Competition Policy*, ch. 2 in Comanor *et al.*, Competition Policy in Europe and North America: Economic Issues and Institutions (Harwood Academic Publishers 1990)).

offerings must therefore be assessed through a dynamic analysis that reflects the *availability* (or capacity) of DBS and the ability and willingness of consumers to switch in response to market signals. Dynamic analysis is particularly important here in at least two respects.

21. First, exercise of buyer market power requires a *credible* threat to withhold carriage if the supplier refuses to accede to the buyer's anticompetitive demands. Here, however, programming suppliers know that in the presence of DBS (and other cable competitors such as overbuilders and MMDS providers), inefficient purchasing decisions by a cable operator – *i.e.*, refusals to carry competitively priced programming that subscribers demand – would impose substantial costs on the cable operator in the form of (existing and future) subscribers lost to rivals. There can be no question that program suppliers would consider this competitive reality in assessing the credibility of any cable company threat. The relevant DBS market share figure is therefore not the existing static market share, but the *potential* DBS share if a cable operator acted on a threat to refuse to carry competitively priced programming that its subscribers want.[3]

22. Second, even apart from its clear relevance to the credibility of a cable company threat to deny carriage, the willingness of customers to choose DBS over cable is highly relevant to the programming supplier's own assessment of its available alternatives. In this regard, I understand that video programming carriage contracts are typically long-term

[3] Of course, not every threat by a cable company to "drop" a channel evidences market power. For example, it is both reasonable and in the public interest for a cable company to refuse to carry a programming channel whose rates are too high relative to the audience it attracts.

contracts (often as long as fifteen years). Thus, in deciding whether alternative distribution outlets are adequate, a video programming supplier would not look merely at the current static market shares of those alternative distributors, but at the expected number of subscribers (and hence the expected subscriber-based fees) over the entire contract period – recognizing, of course, that a cable company's refusal to carry competitively priced programming would likely accelerate the growth rate of the cable company's rivals' subscriber bases.

23. Moreover, the dynamic analysis should also pay particular attention to subscribers to *digital* services. Analysts, and cable companies themselves, view existing analog cable systems as not economically viable over the long run. Thus, cable companies are spending billions of dollars to upgrade their plants to carry digital signals that allow them to match the number of channels offered by DBS. Despite significant strides, DBS has millions more digital subscribers, and a *larger* share, than cable. Given this, and the fact that DBS has been recently freed of restrictions that prevented it from carrying local broadcast signals, programmers have every reason to consider DBS as becoming an increasingly important purchaser of video programming services.

24. Thus, the relevant inquiry is whether given *all* the relevant features of this highly dynamic environment – including all alternative video programming distribution outlets, the costs to a cable company of making inefficient purchase decisions, and the impact of other federal regulations aimed at the same anticompetitive behavior – there is a serious risk that increased cable ownership concentration above some level would threaten video programmers to the ultimate detriment of consumers. *See Notice* ¶ 44 ("We seek to adopt

regulations that are appropriate given the market power of cable operator in today's dynamic and changing MVPD marketplace").

D. Unique Characteristics Of Video Programming.

25. The validity of buyer market power claims can also turn on the nature of the product supplied by the putative "victim." There are several characteristics of the video programming market that are highly relevant to any market power analysis.

26. First, video programming is "non-rival" in consumption – that is, a supplier can sell its programming to as many buyers as it can find without using the product up. This means that the usual underpinnings for the analysis of buyer power need to be re-examined in the context of video programming. As I explain below, the usual explanation for monopsony power is that a large buyer[4] faces an increasing incremental cost of purchasing additional quantities of the input. As a result, such a buyer cuts back on the purchases of the input below the level that would be bought by a firm that faced an elastic supply of the input. Here, however, this standard explanation does not hold because the "incremental cost" of delivering programming to another MVPD does not increase with respect to the number of MVPDs that already receive the programming (or with respect to the number of households being served by a given MVPD). Putting aside additional considerations and complexities that may flow from vertical integration (which I address below in the context of foreclosure theories), there is no reason to assume that a profit-maximizing bundle of programming would change if two stand-alone MSOs were

[4] That is, a buyer who purchases a large share of the input in question.

merged into a single MSO. In particular, there is no reason to believe that a combined MSO with monopsony power would have a newly-found incentive to cut back on programming as compared to the programming purchased by the component MSOs. For this reason, the *Notice's* reliance on traditional monopsony theories of public harm is misguided. *See Notice* ¶¶ 29, 81.

27. Second, programming production often requires large sunk cost investments that are vulnerable to post-investment "hold-up" – *i.e.*, the *ex-post* extraction of surplus (often referred to as quasi-rents) after sunk investments have been made.

28. Programmers, of course, are aware of this possibility and will be unwilling to sink investments if they will be vulnerable to *ex post* exploitation. To induce a program producer or packager to make these investments, therefore, cable operators and other programming distributors must convince the program producer or packager that it will not be held up. But the non-rivalrous nature of programming creates "free-riding" incentives among the distributors – each distributor would like quality programming to be produced, but each wants its rivals to incur the precommitment costs to solve the hold-up problem (so that the free-rider can potentially negotiate a better deal with the programmer after the programmer's fixed costs are sunk and all that has to be covered is the low incremental costs of an additional sale).

29. Unless the free-riding problem can be solved, the investment in programming will not be made (or lower-quality, less expensive programs may be made). In the real world, quality programming is, of course, produced, because there are solutions to such free-

riding problems, including contingent and other contractual arrangements made before all of the investment is sunk.[5] Reputation is also an important consideration that enters into the way the bargains will be struck: an MVPD distributor that has tried to take appropriate the programmers' quasi-rents may find itself disadvantaged in the future negotiations over purchases of new and valuable programs.

30. Third, unlike in the case of rivalrous inputs, where, as here, the input in question has public good characteristics, a buyer's bargaining leverage can actually *decrease* as the buyer grows larger relative to other buyers. The reason is that a very large cable (or DBS) operator would have a less credible threat to refuse to underwrite its share (and perhaps more) of the cost of programming than does a small MSO. Consequently, an increase in the MSO's size can reduce the credibility of the MSO's threat to hold-out or to refuse to contribute its share towards defraying the costs of programming. *See Notice* ¶ 37 ("[t]his problem might be avoided in a single MVPD scenario since the program distributor (*i.e.*, the MVPD) would absorb a greater amount of the sunk costs incurred in the production of new programming (analogous to the "first copy" costs in publishing) in order to ensure the economic viability of essential programmers, and thus the continued supply of high quality programming"). This somewhat counterintuitive insight is supported by recent academic literature, and it means that national limits on cable ownership concentration would be an unproductive (indeed, counterproductive) response

[5] It is important to note that the *ex post* opportunistic behavior is not only the province of the MSOs. Programmers also have incentives to reduce quality of programming after they have signed a long-term contract in order to reduce on the costs of the program. Contractual and other conventions have emerged to deal with this problem as well.

to concerns that a cable company or companies might attempt to "hold-up" a video programmer that has sunk its investment – such free-riding concerns exist independent of, and are, if anything, ameliorated by, increases in cable ownership concentration.

31. Fourth, regarding the issues of foreclosure, it has to be noted that at the outset that cable companies are already subject to specific market forces and conduct regulations that independently limit their ability to engage in anticompetitive exclusionary behavior. The foreclosure concern is, apparently, that a vertically integrated cable company will deny carriage to an unaffiliated programming network (either through an outright refusal to deal or a noncompensatory carriage offer), that the unaffiliated network will be unable to stay in business without that carriage on that MSO's cable systems, and that, after the unaffiliated programmer (network) is weakened or induced to exist, the cable company's affiliated network will be able to increase its rates to other purchasers of programming. Cable companies, however, have no ability to erect an absolute barrier to carriage on their systems to programmers. For example, some content producers may be able to obtain carriage without the cable company's cooperation either by making a carriage deal with broadcast or other networks that are guaranteed cable access through "must carry" regulations, *see* 47 U.S.C. § 534, or by paying for access pursuant to the leased access regulations, *see id.* § 532. Nor is a cable company even free to offer discriminatory carriage terms to rivals of its affiliated programming; the 1992 Cable Act (and accompanying FCC regulations) specifically prohibit such discrimination. *See id.* § 536(a)(3); 47 C.F.R. § 76.1300 *et seq.*

32. It is not my view that one should generally rely on regulations, rather than on market forces, to protect the competitive suppliers of content and the viewers from the pernicious effects of anticompetitive foreclosure. Here, for example, market forces would, even in the absence of existing regulations, sharply curtail the real world ability of any cable operator to prevent producers of desirable video programming from obtaining cable carriage. I understand that in today's marketplace, there are as many as several dozen programming networks (from HBO to ESPN to the Food Network and the Golf Channel) that are *de facto* "must carry" networks (given, among other things, the fierce competition among DBS and cable operators to attract viewers). Any program producer that sells content to one of these programming networks is therefore, for all practical purposes, guaranteed widespread cable distribution of that content. Nonetheless, I am of the view, that to the extent regulations aimed at discouraging foreclosure conduct already exist, those regulations must be factored into the design of a sound public policy, and therefore into the determination whether structural limits on cable ownership concentration are necessary.

33. One can (and I do, below) evaluate the validity of the foreclosure concerns independent of the constraints imposed by the existing regulations. As I explain below, there are many reasons to question even the theoretical risk of anticompetitive foreclosure. But it plainly makes no economic sense to ignore the existing regulations as well as the protection afforded by the antitrust laws.

34. Fifth, video programming is not a commodity, but a differentiated product, generally characterized by unique content protected by copyright. Economics teaches that such

products can command prices that exceed the costs of production and provide economic rents to the owners of the products (and to the talent they hire as inputs to produce the content). In general, existence of such rents raises no public policy concerns. However, bargaining over the distributions of such rents between video programmers and distributors (MSOs, DBS providers, etc.) is inevitable. In the same vein, as there is no concern about the rents, there is no social welfare interest in ensuring that video programmers (or talent) retain all (or, indeed, any) such rents. To the contrary, in some cases, reducing such rents may reduce prices to consumers without any sacrifice in output or quality. Thus, "*bargaining* power" in this context "should not be confused" with the abuse of market power, as the DOJ explained in the hearings leading up to the 1992 Cable Act. *See* Reply Comments of the DOJ, MM Docket No. 89-600, at 5-6 (filed Apr. 2, 1990).

E. Remember The Benefits.

35. Finally, even if it could be demonstrated that increased cable concentration would pose some real, substantial risk of anticompetitive harm to consumers, this alone would not justify government intervention in the form of inflexible structural limits on cable ownership concentration. Like in any other regulatory policy exercises, whether there is a need for limits on cable ownership concentration requires consideration of both the potential costs and the potential benefits of increased concentration. *See Notice* ¶ 6 (Commission must "take into account the beneficial and detrimental effects of cable concentration").

36. For example, an unnecessary (or overly strict) cable ownership concentration rule could impede the development of high speed Internet and digital cable services, particularly in less prosperous localities. An unnecessary (or overly strict) rule could also impede the ability of cable companies to achieve the scale and clustering efficiencies necessary to compete effectively with entrenched incumbent local telephone companies in local telephone and data access markets. The analysis of the need for limits must fully consider these and other potential benefits from increased cable ownership concentration.

F. Summary.

37. I begin my analysis of possible competitive harm in Section III with a survey of the competitive and technological developments in the video marketplace in order to gauge whether various market indicia suggest that increased cable concentration poses a serious risk to video programmers. The evidence suggests that these risks are not significant. There is powerful evidence that market changes since the 1992 Cable Act have greatly diminished the possibility of the exercise of market power by cable MSOs over video programmers.

38. In Part IV, I examine the non-foreclosure theories of competitive harm that have been advanced by proponents of limits on cable ownership concentration, and new theories raised in the *Notice*. Several of these theories are entirely unrelated to the relevant buyer market power abuse inquiry, and none provides a sound theoretical basis for national limits on cable ownership concentration.

39. In Part V, I address the issue of foreclosure. I first apply the established analytical framework for evaluating foreclosure concerns, and demonstrate that foreclosure strategy is unlikely to be either successful or profitable with respect to the purchase of video programming by cable operators, which is a particularly poor environment for a successful foreclosure strategy.

40. Foreclosure is an exclusionary strategy that comes at a price – reduced cable company profits stemming from the loss of subscribers to rival MVPD distributors (and to broadcast TV and other video alternatives) because of inefficient programming decisions. For the strategy to be profitable, the cable losses must be made up with programming gains, which either requires putting the rival programmers out of business or disadvantaging them in the marketplace so that the favored content affiliate can then raise rates to other content distributors.

41. But that strategy runs into serious problems at the outset. Because video programming suppliers have many alternative distribution options, being removed from even a very large cable MSO's channel line-up need not result in a serious competitive disadvantage. As an initial matter, as noted above, given existing regulation and market forces, cable operators cannot (individually or collectively) entirely foreclose a programmer from cable distribution itself. Moreover, even if a large cable operator could induce its programming affiliate's rivals to exit – no simple task if the rivals are already up and running will have already sunk some of their costs[6] – that strategy would be unlikely to

[6] For example, some programmers may have developed a library of movies, "classic" sporting events and other similar programs that can be re-run at no additional cost.

create any lasting opportunities to charge other cable companies supracompetitive rates for the affiliated programming. The explosive growth in the number of new programming networks confirms that entry is not only possible, but commonplace, for innovative programming offerings and such entry would be further stimulated in the event that the foreclosing MSO's affiliated programming were priced at a supracompetitive level. In addition, any prospects for gains from a foreclosure strategy actually *decrease* as concentration increases – as a cable company grows bigger relative to its retail rivals, the base of subscribers of other cable companies for which it can seek to charge supracompetitive rates for its affiliated programming necessarily shrinks.[7]

42. I understand that the accompanying report of Dr. Stanley Besen also demonstrates that the opportunity costs associated with the foreclosure strategy are very high, because once a cable system is built, the incremental costs of serving additional customers are very low – and thus a very high share of the revenue foregone as a result of the foreclosure strategy would otherwise flow straight to the bottom line. Here, it is important to recognize the impact that the nationwide *availability* of DBS – especially given the close substitutability between DBS and cable, *see infra* – has in discouraging any cable strategy that would squeeze/foreclose video programming that consumers desire.

[7] Thus, assume that the cable MSO who wishes to implement a foreclosure strategy has 75% of the cable households. Then, if it follows that strategy, it will incur the costs from consumer switching across all the households it controls. These losses will have to be recouped from the remaining 25% of the households. This may be especially difficult if the affiliated programming is inferior to the programming that was foreclosed by the strategy. On the other hand, if the MSO only controls 25% of the households, foreclosure from these households need not have a substantial adverse effect on the rival programmer as it will continue to have 75% of the households from which to obtain revenue against the (inferior) programming affiliate of the MSO.

43. As detailed below, there are a number of additional, more specific reasons why increased cable concentration is unlikely to create any serious foreclosure risk. Because program packagers often own more than one programming network, they can (and, I understand, often do) strengthen their bargaining position and reduce the risk of foreclosure by, for example, presenting the cable operator with a "take-it-or-leave-it" programming bundle that includes both one or more programming networks that customers view as "must see TV" and less popular program offerings (or by stimulating demand for a less established network by cross-promoting it on a more established network). The conclusion that follows from this analysis is that foreclosure concerns in this context are, at best, highly speculative, given the real world market dynamics.

44. In Part VI, I explain that a subscriber limit may prevent cable companies from achieving some efficient consolidation. As I explain below, there are several identifiable public interest benefits to increased cable ownership concentration. First, economies of scale exist in administration and planning for new technologies and services. Second, an overly strict ownership limit may undermine Congress' goal of encouraging widespread deployment of advanced telecommunications services to *all* consumers, as well as advanced digital cable services. Third, an ownership limit provides a perverse incentive; an MSO that is "too" successful at increasing its subscribership through superior marketing, customer service and provisioning of desired video programming may have to *divest* systems in order to remain under the subscriber ownership cap.

45. I therefore conclude that there is no credible economic justification for structural limits on cable ownership concentration at this time. There is an important asymmetry in error

costs in this context. On the one hand, if an unduly restrictive ownership limit is imposed, it could have a significant, negative impact on the public welfare, by foreclosing consolidation that would benefit the public. On the other hand, error in the opposite direction is unlikely to impose significant costs, given the Commission's ongoing oversight and ability to revisit the issue should conditions change.

46. In Part VII, I examine the alternative measures of market power proposed by the Commission. The "open field" approach upon which the rules rejected by the *Time Warner* court were based is hopelessly flawed, because it is incapable of responding to the court's mandate to reflect the *availability* of non-cable programming distribution channels as a constraint on exercise of market power, as measured by elasticities of supply and demand. As I explain below, reliance on either the Implicit Lerner Index or the "q ratio" to gauge market power in this context would also almost certainly lead to misleading conclusions, given the relevant cost structures. And, although the Herfindahl-Hirschman Index ("HHI") measure of market concentration is practical to implement, it is, like market share, simply a measure of current concentration and thus it does not adequately respond to the court's mandate to reflect the availability of non-cable programming distribution channels as a constraint on exercise of market power vis-à-vis programmers. HHI figures are also of questionable value when used to gauge monopsony concerns and, in any event, are used by the antitrust authorities only as *presumptions* that may be rebutted on the basis of the type of economic evidence discussed here.

47. Finally, in Part VIII, I address two "attribution" rules used to determine whether a stakeholder "owns" a cable system for purposes of the ownership cap. I conclude that the Commission should retain the single majority shareholder "exception," which recognizes that minority shareholders do not control programming when there is a single majority shareholder that controls the cable system. I also address the "sale of programming" criteria – vacated as arbitrary in the *Time Warner* decision – for determining whether a limited partnership interest should trigger attribution. I conclude that the court was correct – there is no economically rational basis for the sale of programming criteria.

III. THE DRAMATIC CHANGES IN THE COMPETITIVE LANDSCAPE SINCE THE PASSAGE OF THE 1992 ACT.

48. When Congress when passed the 1992 Cable Act, cable companies were the only MVPD providers with significant numbers of subscribers. There was concern that the growth of cable would "wipe out" over-the-air broadcasters. Many "independent" video programming networks were relatively modest enterprises.

49. A decade later, the cable threat to video programming appears increasingly suspect and speculative. Cable faces stiff competition, particularly from DBS. Although cable concentration has steadily increased, the video programming industry has flourished and consumers now have far more and better video programming choices than ever before. The prices video programming packagers charge cable companies continue to increase at a rate exceeding the rate of inflation. *See, e.g., 2000 Video Competition Report*, 16 FCC Rcd. 6005, ¶ 24 (2001) (noting that programming expenses rose 12.2% in 1999, and were projected to rise an additional 10.9% in 2000). Over-the-air broadcasters continue

to dominate the competition for prime-time viewers and advertisers, and there are more major broadcast networks today than there were in 1992. *See Dual Network Rule Order*, 16 FCC Rcd. 11114, ¶¶ 3, 20 & n.46 (2001). In short, a wealth of empirical data and trends now suggests not only that cable now poses no imminent threat to video programming diversity and quality but that future cable ownership concentration that once would have been unthinkable would pose no such threat.

50. Non-cable MVPDs already serve more than 23% of multichannel video ("MVPD") customers nationwide, and the non-cable share of the MVPD business continues to experience an annual growth rate of nearly 20%.[8] Most of this growth has come from luring away existing cable subscribers.[9]

51. The driving force behind this growth has been the phenomenal success of DBS. DBS will by year-end 2001 have 17.5 million subscribers, representing 17% of U.S. TV households and more than 19% of MVPD subscribers.[10] Last year alone, DBS grew twenty times faster than cable. *See 2000 Video Competition Report* ¶ 14 (2001) (comparing 1.5% growth rate for cable with 29% growth rate for DBS). This trend is

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[8] *See* Paul Kagan Assocs., *Media Index Database*, Kagan Media Money, at 11 (June 26, 2001) ("*Kagan Media Database*").

[9] See J.D. Power & Assocs., *2001 Syndicated Cable/Satellite TV Customer Satisfaction Study* (Sept. 2001); Declaration of Robert Willig, Application of EchoStar Communications Corp., General Motors Corp., and Hughes Electric Corp. for Authority To Transfer Control, CS Docket No. 01-348, ¶ 11 (filed December 3, 2001) ("Willig EchoStar-DirecTV Merger Dec.") (citing evidence).

[10] *See* Deutsche Banc Alex. Brown, *DBS Signals*, at Table 4, p. 8 (Oct. 11, 2001) ("*DBS Signals*").

continuing in 2001.[11] DirecTV is already the third largest MVPD operator and EchoStar is the sixth largest.[12] "EchoStar adds DBS subscribers so quickly that it could spawn the equivalent of the 11th-largest cable operator every quarter. . . . Meanwhile, cable operators plod along with 1-2% annual growth, with the entire industry adding a million or so subscribers per year. That's basically the rate at which new households are being created."[13]

52. As the Commission recognized in its *2000 Video Competition Report* ¶ 68, much of the recent growth in DBS can be attributed to "authority granted to DBS providers in late 1999 to offer 'local-into-local' service." Indeed, since passage of the Satellite Home Viewer Improvement Act of 1999 ("SHVIA"), DBS operators have increased subscribership by 43% as compared to the pre-SHVIA period. *Id.* ¶ 69. And this strong growth is expected to continue. By 2007, analysts predict that DBS will have over 28 million subscribers.[14]

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[11] Press Release, EchoStar Communications Corp., *EchoStar Reports Over $1 Billion of Revenue, Record EBITDA and Net Income in Third Quarter* (Oct. 23, 2001) ("*EchoStar Press Release*") (available at http://www.corporate-ir.net/ireye/ir_site.zhtml?ticker=dish&script=410&layout=-6&item_id=218915); Press Release, Hughes Elecs. Corp., *Hughes Revenue Grows by 25%; Strong DIRECTV U.S. Subscriber Growth Beats Expectations* (Oct. 17, 2001) ("*DirecTV Press Release*") (available at http://www.hughes.com/ir/pr/01_10_17_3rd_quarter.xml).

[12] *Compare* SkyREPORT, *National DTH Counts November 2000 – November 2001* (reporting that DirecTV has 10.58 million subscriber and EchoStar has 6.67 million subscribers) (available at http://www.skyreport.com/dth_us.htm) *with* National Telecom. Cable Ass'n, *Top 25 MSOs* (available at http://www.ncta.com/industry_overview/ top50mso.cfm).

[13] *Cable Slows, DBS Sprints*, Broadcasting and Cable, at 29 (June 4, 2001).

[14] *See DBS Signals* at Table 4, p. 8.

53. C-Band, MMDS, and SMATV operators also have made inroads against cable.[15] I also understand that broadband overbuilders such as RCN and Knology have emerged as strong competitors in some cable markets, and that incumbent local exchange carriers ("LECs") and leading electric and gas utilities, are poised to provide competing services.[16]

54. This increasing availability of alternatives is also reflected in the series of Commission orders declaring that hundreds of markets in the U.S. are effectively competitive at the retail level. These orders recognize that cable MSOs face competition from a broad array of competitors, including not just DBS operators,[17] but also incumbent LECs,[18] cable

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[15] Although SMATV subscriber counts have remained constant in recent periods, they are expected to see growth in the next year. *See Kagan Media Index Database* at 11.

[16] *See 2000 Video Competition Report* ¶¶ 119-120.

[17] *See, e.g.*, Memorandum Op. and Order, *Mountain Cable Co., et. al., Petitions for Revocation of the Certification of the Vermont Public Service Board to Regulate Basic Cable Service Rates*, DA 99-1749 (Sep. 2, 1999); Memorandum Op. and Order, *Cable USA, Inc., Petition for Special Relief Requesting a Finding of Effective Competition in Various Nebraska Communities*, DA 01-1947 (Aug. 16, 2001).

[18] *See, e.g.*, Memorandum Op. and Order, *Time Warner Entertainment Co., L.P., Petition for Determination of Effective Competition*, 11 FCC Rcd. 17298 (1996); *Time Warner Entertainment-Advanced/Newhouse Partnership, Petition for Determination of Effective Competition*, DA 96-2094 (Dec. 12, 1996); Memorandum Op. and Order, *Paragon Communications, Petition for Determination of Effective Competition*, DA 97-566 (March 18, 1997); Memorandum Op. and Order, *Cablevision Systems of Conn. L.P., Petition for Determination of Effective Competition*, DA 99-1815 (Sep. 9, 1999).

overbuilders,[19] electric utilities,[20] municipal cable systems,[21] and wireless services like MMDS.[22] This competition is broad-based – DBS penetration exceeds 15% in 40 different states.[23]

55. Cable channel capacity – which needs to be filled with attractive programming to make the investment economic – has increased significantly since 1992. Spurred by competition from DBS, cable operators have been spending billions to upgrade their systems to provide comparable capacity.[24] DBS, however, still leads the race for the "digital subscriber." Analysts estimate the digital cable subscriber count at year end 2001 at 15.1 million, compared to 17.5 million for DBS.[25]

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[19] *See, e.g.*, Memorandum Op. and Order, *TCI TKR of Alabama, Inc., Petition for Special Relief*, DA 97-2688 (Dec. 24, 1997); Memorandum Op. and Order, *Time Warner Entertainment-Advanced/Newhouse Partnership, Petition for Determination of Effective Competition*, DA 99-285 (Feb. 5, 1999).

[20] *See, e.g.*, Memorandum Op. and Order, *TCI of Northern Iowa, Petition for Revocation of Certification of the City of Cedar Falls, Iowa to Regulate Basic Cable Service and Equipment Rates*, 12 FCC Rcd. 18236 (1997).

[21] *See, e.g.*, Memorandum Op. and Order, *Time Warner Cable, Petition for Revocation of the Certification of the City of Lebanon, OH to Regulate Basic Cable Service and Equipment Rates*, DA 99-2760 (Dec. 10, 1999).

[22] *See, e.g.*, Memorandum Op. and Order, *Falcon Telecable, Petition for Reconsideration of the Certification of the City of Sinton, Texas to Regulate Basic Cable Rates*, 10 FCC Rcd. 1654 (1995).

[23] *See* SkyTRENDS SkyMAP (Apr. 1, 2001); www.skyreport.com.

[24] Stratecast Partners, *U.S. Cable MSOs: Strategic Market Assessment & Forecast* 7 (Sept. 2001) (noting that cable operators' "plant upgrades were/are mandatory, not optional, as part of their efforts to grow their businesses and compete effectively against current and future combatants including DBS and telecommunications service providers").

[25] Deutsche Banc Alex. Brown, *Cable Industry Outlook*, at 49 (Sep. 6, 2001).

56. At the same time that there has been explosive growth in alternatives to incumbent cable companies, the predicted demise of broadcast TV has failed to materialize. The "Big 3" broadcasters remain strong, and Fox, UPN, WP and PaxTV also now serve most major markets. *See Dual Network Rule Order* ¶¶ 3, 20 n.46. The "must carry" provisions of the 1992 Cable Act require cable systems to carry broadcast stations (and to include them in "basic" tier service), and recent legislation permits DBS to carry broadcast TV stations as well. *See* Satellite Home Viewer Improvement Act of 1999, Pub. L. No. 106-113, 113 Stat. 1501, 1501A-526 to 1501A-545. Indeed, I understand that SHVIA has a "carry one, carry all" rule which means that even relatively "weak" broadcasters get free access to DBS in markets where DBS carriers local channels. These are very attractive venues for firms that want to launch new situational comedies and dramatic series. Consequently, the availability of these distribution channels means that some producers of content do not have to get direct distribution on cable (*i.e.*, on channels whose carriage is at the discretion of an MSO), in order to reach viewers.

57. Moreover, with the transition to digital broadcasting, broadcasters are able to multicast video programs and become even larger consumers of video programming. In particular, recently developed digital compression technology will permit TV broadcasters to transmit up to six different channels all carrying different programming using their current spectrum.[26] This is highly relevant to this proceeding because it means more sources of demand for programming.

[26] *See* http://www.kqed.org/tv/dtv/info.html.

58. The analysis of revenue sources for content manufacturers, and hence their dependence on cable, cannot be limited to the U.S. More and more programming produced in the U.S. is being carried abroad by foreign MVPDs and TV broadcasters. Foreign video programming distributors also are purchasing vast amounts of video programming, and foreign sales are becoming a significant portion of many programming networks' business. This trend is bound to increase as a result of the sustained growth in cable and satellite television world-wide and the current conversion towards digital television in many significant markets, such as Australia or Europe. As a result, video programmers increasingly look to foreign market distribution as an important source of revenues and thus a relevant consideration in terms of the incentives to invest in new, high quality programming. Indeed, U.S. cable subscribers now constitute less than a quarter of the 317 million worldwide subscribers for which cable and DBS distributors purchase video programming.[27]

59. For example, among Viacom's program networks, MTV reaches 370 million households in 140 countries; Nickelodeon is seen in over 300 million households worldwide; VH1 reaches 100 million households worldwide; and BET International reaches 30 countries in Europe and 36 countries in Africa.[28] Disney's ESPN International already reaches more than 80 million homes and distributes programming to most countries around the globe.[29] Similarly, E! Entertainment Television, which reaches 60 million cable and

[27] *See* NCTA, *Industry Statistics* (available at http://www.ncta.com/industry_overview/indStat.cfm?indOverviewID=2)

[28] *See* Viacom Inc., *The Facts* (available at http://www.viacom.com/thefacts.tin).

[29] The Walt Disney Co., Annual Report, at 37 (2000).

direct broadcast subscribers in the U.S., is available to 400 million homes in 120 countries worldwide.[30]

60. AOL-Time Warner programming also benefits from large coverage abroad: CNN is seen in more than 151 million television households in 212 countries worldwide. Cartoon Networks is available in 145 foreign countries. Turner Classic Movies has emerged as a global brand with the launch of feeds in Poland, Spain, France and the UK and regional feeds in Scandinavia, the Netherlands, Eastern Europe, Africa and the Middle East. HBO's international joint ventures reach 12 million subscribers in more than 50 countries in Latin America, Asia and Central Europe.

61. The Fox News Channel is distributed in more than 30 countries in Europe, Asia and Latin America and Fox Kids programs are sold in several foreign countries.[31] MGM has expanded its programming network portfolio "in order to combine the Company's critical mass of library content with the explosive growth of worldwide cable, satellite and digital platforms."

62. In sum, this evidence suggests for many content providers the relevant revenue stream is global. This in turn reduces these content providers' financial dependence on U.S.

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[30] And U.S. video programmers also sell to foreign broadcast networks. Disney claims to have worldwide leadership in television broadcasting, distribution and production. According to its 2000 Annual Report, Walt Disney Television International owns 13 broadcast channels around the world, and distributes more than 4,200 hours of programming in 120 countries. Disney-branded shows now air in 42 countries, a majority of which consistently win their time slots. *Id.* at 24.

[31] *See* www.foxnews.com/foxfan/international.htm

sources of revenues and thus lessens the risk of the exercise of monopsony power or the risk of anticompetitive foreclosure by U.S. distributors.

63. The vibrancy, breadth, and strength of the video programming marketplace is further confirmed by the fact that the rates video programmers charge for their products have consistently *increased* well in excess of the general rate of inflation. This is not surprising, given the seemingly inexorable thirst for content. The Commission itself has found that cable operators' programming costs – one of their largest components of total costs – have increased more than 10% over each of the last two years (and that cable infrastructure expenses rose dramatically as well).[32] According to the NCTA, between 1996 and 2000, the cable industry spent over $36 billion on basic and premium programming – roughly 75 percent more than the $ 20.6 billion it spent during the previous five years.[33] Thus, despite the increase in concentration at the cable level, there is no evidence that there has been an adverse effect on the ability of programmers to produce and profitably distribute the type of content that consumers want to view.

64. Finally, vertical integration – *i.e.*, ownership of upstream programming and downstream distribution by a single entity – remains on the decline. I understand that there are currently more than 280 cable networks operating in the U.S; that the total number of cable networks has increased fourfold over the last decade; and that the level of vertical

[32] *See 2000 Video Competition Report* ¶ 24 (noting that programming expenses rose 12.2% in 1999, and were projected to rise an additional 10.9% in 2000), ¶ 33 (estimating that capital expenditures increased 17% in 2000).

[33] *See* Robert Sachs (NCTA), *Prepared Testimony before Senate Committee re: Cable and Video: Competitive Choices* (April 4, 2001).

integration has dropped every year since 1995.[34] Following AT&T's spin-off of Liberty Media, the National Cable Television Association estimates that now only 73 (or 26%) of the 281 national programming networks now are affiliated with cable.[35]

65. These trends evidence a reduction in the video programmers' dependency on cable distribution and the reduction in the number of vertically integrated networks suggests that the MSOs are not actively exploiting the alleged benefits from anticompetitive foreclosure strategies. Hence, the Commission should not, as a precautionary measure, tip the scales in favor of proponents of ownership concentration limits. To the contrary, where, as here, a survey of the most relevant market trends overwhelmingly demonstrates a vibrant marketplace for video content, proponents of government regulation of horizontal ownership bear a heavy burden to prove that there is a real and serious anticompetitive risk that warrants such inflexible structural regulation (notwithstanding continued antitrust and other regulatory vigilance) will create any real and serious

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[34] *See 2000 Video Competition Report* ¶¶ 134-35, 173 & Tables D-6 to D-7; *1999 Video Competition Report*, 15 FCC Rcd. 978, ¶ 179 & Tables D-6 to D-7 (2000); *1998 Video Competition Report*, 13 FCC Rcd. 24284, ¶ 159 & Tables D-6 to D-7 (1998); *1997 Video Competition Report*, 13 FCC Rcd. 1034, ¶ 158 & Tables F-6 to F-7 (1998); *1996 Video Competition Report*, 12 FCC Rcd. 4358, ¶ 142 Tables 6 to 7 (1997); *1995 Video Competition Report*, 11 FCC Rcd. 2060, ¶ 150, Tables 6 to 7 (1996); *1994 Video Competition Report*, 9 FCC Rcd 7442, ¶¶ 161-62 & n.434, 167 (1994); *Competition, Rate Deregulation and the Commission's Policies Relating to the Provision of Cable Television Service*, 5 FCC Rcd. 4,962, 5,109-10 & Tables 4-5, 7-8 (1990).

[35] *See Status of Competition in the Multichannel Video Programming Distribution Marketplace: Hearings Before the House Commerce Comm.*, Subcomm. on Telecommunications and the Internet, 107th Cong. 2 (Dec. 4, 2001) ("NCTA Testimony") (available at http://www.ncta.com/press/press.cfm?PRid=205&showArticles=ok).

anticompetitive threat. As I demonstrate in the next two sections, that burden has not been met.

IV. NON-FORECLOSURE THEORIES OF COMPETITIVE HARM DO NOT PROVIDE ANY BASIS FOR LIMITS ON CABLE OWNERSHIP CONCENTRATION.

66. The traditional economic concern identified with a large purchaser of a particular good or service is that the purchaser might gain monopsony power over sellers of the good or service. A purchaser with monopsony power can unilaterally constrict the amount of a good or service its purchases and thereby lower output below a socially optimal level. Such a decision is only rational (*i.e.*, profit-maximizing) if the monopsonist faces an increasing marginal cost of the input. If the long-run supply curve is flat, then even a firm with apparent (short-run) monopsony power may elect not to exercise such power.

67. My analysis shows that the traditional concerns with monopsony power are not readily (if at all) applicable to the instant public policy question. The existing body of economic literature dealing with the ability of a purchaser to exercise monopsony power over a seller was developed in the context of "rivalrous" goods – *i.e.*, goods that when sold to one buyer cannot be sold to another buyer. Most goods and services have this characteristic. A TV set sold to party A cannot also be sold to party B; medical services provided to one person are of no help to anyone else. Video programming, however, is "non-rival" in consumption. A supplier can sell its programming to as many buyers as it can find without using the product up. This critical fact undermines the normal intuition that a "large" purchaser may be willing and able to exercise monopsony power over a seller. Indeed, it is clear that even a large purchaser of content (as measured by the

number of viewers who receive this content) purchases precisely the same "amount" of content as a much smaller purchaser. Likewise, combining two MSOs into one will not "double" the amount of particular content that the enlarged MSO will buy: if each bought 24 hrs of ESPN, for example, then after the merger, the entity will still buy 24 hrs of ESPN. Putting aside any foreclosure concerns, this leads to a base-line conclusion that as a cable MSO gets bigger it does not change the MSO's incentive to purchase "less" programming.

68. The distinction between the effects of a merger on demand for the input when the input is rivalrous *versus* when it is not can be illustrated by means of a specific example. Suppose that two hospitals, which draw on the same labor pool but compete in different output markets, are each willing to pay up to $33K for a nurse. Assume that there are two nurses available willing to work for $25K and for $30K, respectively, and that each is of equal ability. The equilibrium market price for nurses is then $30K. Each hospital will hire one nurse, because the marginal benefit of hiring the nurse ($33K) is greater than the marginal cost ($30K).

69. Suppose the two hospitals merge and that the combined company becomes a price setter in the input market. Then the merged firm can hire one nurse for $25K, or two nurses for $30K each.[36] Critically, the marginal cost of a second nurse is not $30K, but rather $35K (the $60K cost of two nurses minus the $25 K cost of one nurse). In essence, the

[36] In this example, I assume away price discrimination by the hospital. If the hospital could price discriminate, it would hire both nurses at the nurses' reservation prices. In that case there would be no social welfare loss but the merger would enable the hospital to capture the cheaper nurse's "surplus" (or quasi-rent).

marginal cost of the second nurse rises above the supply curve, and the monopsonist responds by hiring fewer nurses. Thus, in my example, the merged hospital will hire only one nurse instead of two, even though the marginal benefit of hiring the second nurse ($33K) is higher than the price for which she is willing to work ($30K).

70. Now, let us switch the example to the purchase of programming by a cable MSO. Again, assume that there are two different MSOs in different local retail markets and that programming available from either of two suppliers is worth $33K to each MSO. As above, assume equal quality of programming, and that each MSO has one channel slot to fill. Also, as above, assume one programmer is willing to sell to each MSO for $25K, and the other for $30K (and, therefore, the programmers need to make in toto $50K and $60K, respectively, in order to cover their costs). If each MSO is a "price taker," then both will purchase the cheaper program at a price of slightly below $30K (say $29K).[37] If the two MSOs merge, then the merged entity will still purchases the same program that would have been purchased by the stand alone MSOs.

71. However, the price the merged MSO pays depends upon the details of the parties' negotiating strategies and relative bargaining position. For example, if the combined MSO knows the programmers' reservation price, it could try to make a "take-it-or-leave" offer of $50K to both programmers to induce the "cheaper" programmer to sell close to its reservation price. On the other hand, if the MSO does not know the reservation price

[37] This assumes that the two suppliers compete on price against each other in offering their programs to the MSOs and that the supplier with the lower "reservation" price offers its service slightly below the higher reservation price of the other supplier.

of the programmers and both parties have comparable negotiating skill, a deal could be struck whereby the MSO and the cheaper programmer arrive at a deal somewhere between the $58K that the individual MSOs paid in aggregate and the $50K that the programmer needs to make to cover its costs. In short, the effect of combining the two cable MSOs does not lead to a constriction in demand. The only possible effect is redistribution of any "rents" obtained by programmers to the combined MSO – *i.e.*, pushing prices paid for programming closer to the programmer's reservation price. *See also infra* note 46. Such redistribution, by definition, is socially neutral.

72. The difference between the nurse example and the programming example is that purchase from one input supplier by one MSO does not prevent the second MSO's purchase of the same input from the same input supplier. For that reason the marginal cost to the putative monopsonist of purchasing an additional unit is, in principle, the same as the marginal cost to a competitive buyer. Because the input programming is not used up, the profit-maximizing decision made by the putative monopsonist MSO about which program(s) to purchase is the same as the profit-maximizing decisions of separate cable operators. The survival of programmers and the prices offered for programs are, therefore, determined by the marginal values of programming on each cable system, the costs of the programming, as well as the details of negotiations between the willing buyer and a willing seller.

73. Note also that the traditional theory of monopsony harm depends critically on the inability of a purchaser to "price discriminate" in the input market.[38] In contrast, where a buyer can engage in perfect price discrimination, it will not constrict purchases of the input.[39] Thus, even if one could ignore the analysis above and pretend that traditional monopsony theory were appropriate, there would still be considerable doubt that a cable MSO with putative monopsony power would reduce output because such an MSO would likely engage in price discrimination.

74. Critically, there is also no reason to believe that a hypothetical cable MSO with putative monopsony power would reduce quality even when it is recognized that programming quality is not fixed but depends on the fees programmers collect from distributors. To be sure, a "price setting" MSO, like a "price taking" MSO, would like to pay as little as possible for the programming it buys, whatever its quality. But a cable MSO's demand for quality is determined by consumer demand and retail competition that are independent of the size of the MSO and of whether it has, or lacks, "monopsony" power. Rather, all MSOs desire programmers to produce and sell programming that maximizes the number (and "quality") of viewers relative to the economic costs of the programming.

75. For example, assume that programs can be of high quality ("Hi") or low quality ("Lo"). To produce Hi costs $1MM and to produce low costs $0.8MM. Whether a cable MSO

[38] This point is not unique to non-rivalrous goods, but is true generally where a monopsonist can price discriminate.

[39] The only exception to this would be if the putative monopsonist also gains incremental monopoly power which, however, is not related to monopsony power.

would prefer to purchase a Hi or Lo program depends on the share of the total cost that is required to defray and on the effect of the quality of programming on the number of subscribers and other pertinent measures of demand.[40] It is clear that combining two non-competing MSOs does not change that calculus, unless a large MSO may have to contribute a *higher* share of programming costs, which would hardly evidence monopsony power.[41]

76. Thus, in this context, a cable MSO with putative "buyer power" (as gauged by its share of MVPD households) does not have any incentive to "squeeze" programmers so hard that the quality or quantity of programming it purchases is degraded below the proper benchmark. Rather, whatever "buyer power" it may have would manifest itself in the negotiations between the cable MSO and the programmer with regard to how the joint surplus created when the programmer agrees to sell programming to the MSO is split between the two parties. The "monopsonist" MSO may be able to gain a larger share of

[40] For example, advertisers are not only concerned with the number of viewers ("eyeballs") but also with the quality of the viewers.

[41] In fact, as I discuss below, there is reason to believe that large MSOs will in fact pay a higher share of programming costs.

the surplus than a smaller MSO – although this is far from clear[42] – but how this surplus is divided between the parties, of course, raises no public interest concern.[43]

77. Although traditional monopsony power is not a concern, that does not mean that programmers are necessarily immune to "exploitation" by a cable operators. Video programming has public good characteristics. Programming production requires large sunk cost investments that are vulnerable to post-investment "hold-up." Once a programmer had sunk its costs and produced a program, cable operators might demand that the programmer sell them programming at marginal costs, which would not allow the programmer to recover its forward-looking investment.

78. Programmers, of course, are fully aware of this and can protect themselves *ex ante*. Thus, to induce a program producer or packager to make these investments, cable operators and other programming distributors must convince the program producer or packager that it will not be "held up." But the non-rivalrous nature of programming creates "free-riding" incentives among MVPDs – each distributor would like quality programming to be produced, but each wants its rivals to incur the costs of solving the hold-up problem (so that the free-rider can then negotiate a better deal with the

[42] It is impossible to say with precision whether even a hypothetical "100%" cable MSO would be able to extract the entire surplus from the programmer. The split of the surplus would depend upon the relative bargaining strengths of each party, such as the popularity and uniqueness of the programming, the size of the programmer, and the ability of the programmer to deploy its capital to other uses. In fact, as explained below in greater detail, by becoming larger an MSO can actually weaken its bargaining position.

[43] The one caveat to this statement is that, to the extent the cable MSO faces effective retail competition, the public will benefit from the exercise of "buyer power" because cost savings achieved by the cable MSO will be passed along to consumers.

programmer after the programmer's fixed costs are sunk and its marginal costs of an additional sale are very low). Unless the free-riding problem can be solved, the investment in programming will not be made (or lower-quality, less expensive programs may be made). There is a large body of academic literature that discusses the many mechanisms that can be used to solve such free-riding problems, *e.g.*, contingent and other contractual arrangements made before all of the investment is sunk.[44]

79. Of fundamental importance here, however, is that where the input in question has public good characteristics, a buyer's bargaining leverage can actually *decrease* as the buyer grows larger relative to other buyers. Because of the public good nature of programming, a larger MSO can less credibly threaten to hold-out and refuse to pay its "fair share" of programming costs than a smaller MSO.[45] This is so because a large cable MSO may have more to lose than small MSOs from non-carriage (or lower program quality). In other words, the more subscribers that a MSO serves, the more it stands to lose from refusing to carry programming that those subscribers value. Therefore increases in size *reduce* the credibility of the MSO's threat to hold-out until the free-riding problem is solved. *See Notice* ¶ 37 ("[t]his problem might be avoided in a single MVPD scenario since the program distributor (*i.e.*, the MVPD) would absorb a greater amount of the sunk

[44] The seller who has been held up once will not be willing to commit the needed resources in the future thereby leaving the monopsonist without the source of the input. This could be very costly to the monopsonist who may also have long lived and specialized assets that would be rendered valueless without the input.

[45] This is true when the total willingness for programming exceeds the forward-looking total costs of production of programming. When total willingness just equals the pertinent cost, there is no room to free-ride.

costs incurred in the production of new programming (analogous to the "first copy" costs in publishing) in order to ensure the economic viability of essential programmers, and thus the continued supply of high quality programming").

80. There is now a growing body of academic literature on this point. For example, in his recent paper, *Pivotal Buyers and Bargaining Position*[46] DOJ economist Dr. Andrew Raskovich formalizes this insight and demonstrates that a "pivotal" buyer of video programming would be unable to exercise significant bargaining power, let alone market power, against programmers. Dr. Raskovich explains that in industries characterized by high fixed costs and low marginal costs, a "pivotal" buyer[47] internalizes the effect of hard bargaining on the supplier's decision to sink costs. In other words, a key buyer knows that if it insists on too low a price, a supplier is going to be unwilling to make the investments necessary to produce either the quantity or the quality of the product or service desired by the buyer. *See id.* at 22 ("Bigger is not always better in a bargaining context. If a buyer grows so large as to become pivotal to the supplier's production decision, the buyer loses the ability to credibly abdicate responsibility for ensuring that the supplier's costs are covered.").

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[46] Alexander Raskovich, *Pivotal Buyers and Bargaining Power*, DOJ Economic Analysis Group Discussion Paper 00-9 (2000).

[47] A buyer is pivotal if the other buyers in aggregate will not provide a supplier with sufficient funds for covering the supplier's fixed costs. Thus, without a contribution from the pivotal buyer, the supplier will be unwilling to sink the fixed costs necessary to produce the good/service at issue.

81. Likewise, in *The Role of Firm Size in Bilateral Bargaining: A Study of the Cable TV Industry*, 81 Review of Economics and Statistics, 326-340 (1999), Professors Chipty and Snyder examine the effect of buyer merger on bargaining power in cable television markets. *See also* Tasneem Chipty, *Horizontal Integration for Bargaining Power: Evidence from the Cable Television Industry*, 4 Journal of Economics and Management Strategy, 375-397(1995). The authors present a theoretical model of a bargaining game between a single supplier (programmer) and N buyers (MSOs) and demonstrate that buyer merger can weaken the buyers' bargaining position, depending on the curvature of the supplier's gross surplus function (revenue minus cost).[48] According to the authors' empirical estimates, the gross surplus function is generally convex for sizes of program networks seen in the data. Thus, merger between cable television systems actually reduces their bargaining power in the programming market.

82. This analysis also explains why the *Notice*'s related concern that a "large MSO" may gain an unfair competitive disadvantage against "overbuild entrants due to the large programming license fee discounts the incumbents receive" is unfounded. *Notice* ¶ 30. As the *Notice* explains, under this theory, overbuilders "may be forced to pay programming license fees that are so high that continued operation is unprofitable." *Id.* The theory thus assumes that a large MSO will only pay a small fraction of the fixed costs necessary to develop a program leaving the programmer to collect a large portion of the fees from the overbuilder(s). Because of this cost differential, the theory

[48] The model assumes a Nash bargaining game in which, in equilibrium, total surplus is spread equally between the supplier and each buyer.

hypothesizes, an overbuilder would not be able to compete and would be driven it from the market.

83. This argument is flawed. As I explained above, a programmer will not sink its costs if it does not expect to recover them. Rather, faced with the scenario described in Paragraph 30 of the *Notice*, the programmer would never develop the programming in question because it knows that if incumbents that serve the vast majority of subscribers refuse to pay the fair share of the costs, the programmer may not be able to recover its remaining costs. Clearly, if the overbulider is forced to exit and the incumbents do not contribute enough, then the programmer will not recover its costs and will refuse to invest on a forward-looking basis. Indeed, with respect to the pre-existing programming, the overbuilder actually benefits from the willingness of the incumbents to contribute sufficient amounts to bring forth the desirable programming. Thus, assume that revenue flow from the existing MSO contracts is sufficient to cover the full forward-looking costs of the content at issue. Then, the late entrant (such as an overbuilder) can be served at a low price since the revenue from the overbuilder is (essentially) pure profit.[49]

84. In this regard, it is also important to recognize that the fact that large MSOs may pay lower per-subscriber fees than smaller distributors is not inherently anticompetitive. To the contrary, it is well-recognized that such volume discounts are generally pro-

[49] There is a bottom price below which the content provider will not be willing to discount since further advantaging the overbuilder causes programming revenues from the incumbent MSO to fall to the potential determinant of programmer's profits. *See* Janusz Ordover and John Panzar, *On The Non-Linear Pricing Of Inputs*, 23 International Econ. Rev. 659 (1982).

competitive.[50] Discounts to large MSOs are warranted because it is less costly for programmer-sellers to deal with larger buyers. *See infra* Part VI. Volume discounts are also warranted because the marginal cost of delivering the program to an additional household is low (relative to the total cost) and thus efficiency calls for volume discounts. Volume discounts may also ameliorate the free riding problem discussed above. As noted, large MSOs are more likely to be the entities that make the financial commitment necessary to allow the programmer to recover its costs thereby making production of the programming possible. A most-favored-nation clause and/or volume discounts allows a large MSO to protect itself from smaller MSOs obtaining a much better rate from the programmer after the programmer has been assured recovering of its fixed costs from its agreement with the large MSO(s).

85. In short, although hold-up and free-riding issues clearly arise in this context, they are not caused by cable ownership concentration, but by the cost structure and non-rival nature of video programming. Market participants have apparently found ways to address these issues through contractual, reputational, and other means. And limits on cable ownership concentration could do nothing to improve on the market solutions. To the contrary, as explained above, such limits could well exacerbate any "hold-up" problems, because

[50] *See, e.g.*, Janusz Ordover & Robert Willig, *Economist's View: The Department of Justice Draft Guidelines for the Licensing and Acquisition of Intellectual Property*, Antitrust (Spring 1995) ("[V]olume-sensitive pricing, in particular volume discounts . . . . enhance downstream efficiency and thus should be regarded as procompetitive."); DOJ/FTC, *Statements of Antitrust Enforcement Policy in Health Care*, 4 Trade Reg. Rep. (CCH) ¶ 13,153, at 20,812 (1996) (joint purchasing agreements can allow participants to "obtain volume discounts" that "allow the participants to achieve efficiencies that will benefit consumers"); *see generally* Jean-Jacques Laffont and Jean Tirole, *Competition in Telecommunications* Ch. 2 (MIT Press 2000).

increased cable ownership concentration would better align the incentives of MSOs and video programmers with regard to the production and distribution of quality programming.

86. In addition to monopsony and hold-up concerns, the *Notice* asks for comment on several other economic theories that have not to date formed the basis for Commission inquiry into the proper limits on cable ownership. In my opinion, these economic theories could not support national limits on cable ownership concentration.

87. For example, the *Notice* asks whether an ownership limit is necessary to deal with the "problem" of "competition *for* markets, not competition within markets." The *Notice* states (¶ 32):

> All cable systems in the United States are locally franchised, and local franchising authorities ("LFAs") review franchisee performance at renewal time. It is possible that the existence of multiple MSOs provide LFAs with alternatives at least as a means to compare the performance of the incumbent against other operators, referred to in the literature as "benchmarking." If so, then the existence of multiple MSOs could provide a helpful check on MSO practices in their franchise areas. Further, under some circumstances, it may be helpful for LFAs to refer to franchise agreements negotiated in other franchise areas with different MSOs, particularly as evidence that elements of those franchise agreements are not financially ruinous.

I understand that federal law prohibits LFAs from basing franchise decisions on the cable operator's programming choices, and thus any "benchmarking" that turns on the operator's programming choices would therefore be unlawful. *See* 47 U.S.C. § 546(c)(1)(B). Moreover, the *Notice* is silent on how many independent MSOs would be sufficient to perform such "benchmarking" exercise. Accordingly, imposing a horizontal ownership limit in order to facilitate "benchmarking" is quite remote from the